PCM
PEAK CAPITAL MANAGEMENT

Handle With Care

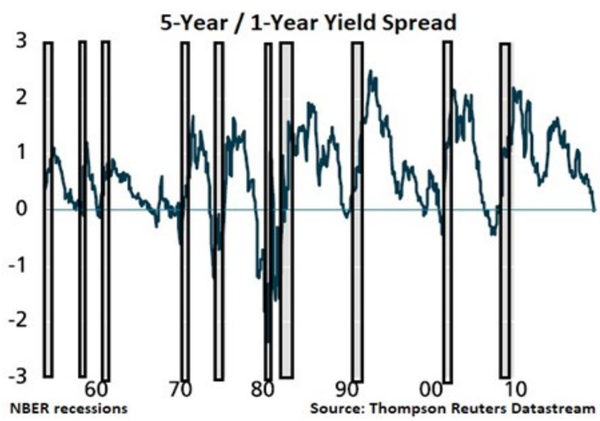
PCM Report March 2019 Volume 10, Issue 3

Brian Lockhart, CFP®

Fragile. That single word might best describe the state of the global economy and markets, and I am not referring to the Italian word from the classic, ***A Christmas Story***. If the current trends remain, even the most bullish commentators and analysts will have to concede — we are on the verge of ending the expansion that began ten years ago. This month we look at the challenges facing consumers, the economy, and the markets to identify the data points that might allow us to not be buried in the coming tsunami.

CONSUMERS

The fiscal health of the average American is at levels we have not seen in decades. According to Bankrate.com, 29% of consumers today have more in credit card debt than they have in savings. This figure is 32% higher than just 3 years ago. Their data also revealed that only 39% of consumers have enough in savings to pay for a $1,000 emergency room visit or car repair without using debt. The deteriorating balance sheets have been largely masked by the strong labor market and recent growth in wages. Sadly, the median retirement savings for the 55-64 age group is only $107,000 (GAO) that would only provide $310/month in retirement income.



ECONOMY

Debt is often referred to as the mother's milk of a growing economy but we are discovering that in excess it turns from benevolent to a malevolent force. Whether it was the result of the market rout in December, the government shutdown, or a host of other factors, small business optimism and consumer confidence is plunging at an alarming rate back to 2016/2017 levels. This decline is ominous for capital and consumer spending forecasts. Corporate America is equally facing a debt crisis, as trillions in debt will soon have to be rolled over at higher interest rates. A record 49.2% of investment-grade debt today is rated BBB, only one notch from junk levels, according to Bloomberg. The leveraged loan market in the U.S. now exceeds $1T (IMF) with much of it covenant-lite. The 5-year/1-year yield spread on Treasuries has been negative since December and as the chart shows, recessions are typically not far behind that inversion.

MARKETS

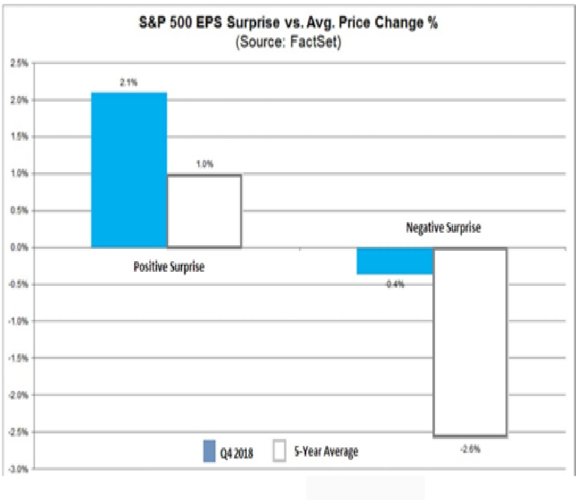
Much has been made of the Fed's about face in January following the carnage in the market at the end of 2018. Liquidity was being removed at a pace of $50B per month and the Fed hoped that the markets would ignore the potential impact. QT is magnified when you consider the government is running a $1T deficit, meaning $1.5T of liquidity is being stripped out of the market each year. The impact on risk assets was highlighted in December when Chairman Powell announced that the Fed had taken the economic Hippocratic oath of "first do no harm." If the market peak occurred in September 2018, there is much more downside risk from where the recovery rally is today than upside potential. Bellwether sectors like housing, automobiles, and capital spending have already rolled over and are showing steep declines as they are the most vulnerable if the Fed has taken tightening too far. The most recent Fed statement removed the phrase that risks to outlook are "roughly balanced." I would suggest the Fed is keenly aware the top is in and investors would be wise to take note as well.

WHAT TO DO

Even in the most fragile economies and markets there are opportunities, or at least places to hide from the majority of the pain that will be inflicted upon traditional buy and hold investors. Recessions are a normal part of the business cycle and the country will emerge on the other side with healthier corporate and consumer balance sheets and some painful lessons learned. Here are some ideas that have historically worked in this environment:

- Go Long Duration: long duration U.S. Treasuries are very likely to perform well as interest rates are cut back down near 0% in the next recession. Investors fearing a bond market collapse will likely miss an opportunity to protect their portfolios when rates fall.
- Own Defensive Sectors: not all sectors of the stock market fall in tandem during a recession. Historically defensive sectors like healthcare and utilities should outperform. The aging of the population suggests spending on healthcare will continue to rise and falling interest rates will be a boon for high quality utilities.
- Consider Energy: this sector has struggled underperforming the S&P 500 by 25% over the last 2 years and a staggering 75% on a trailing 5-year basis. If the USD peaks and heads lower energy is positioned to be the best performing sector.

Rose-Colored Glass Half Full



With nearly all S&P 500 companies reporting Q4 earnings, results can be viewed as a mixed bag. According to FactSet data, 69% of companies reported better than expected earnings and 61% beat on revenue. Both figures are slightly higher than the 5-year average for positive surprises. It looks like earnings per share will increase 13% in Q4 posting the 5th consecutive quarter of double-digit earnings growth. What is surprising, however, is how tame earnings misses have been treated. The average price decline when a company misses earnings has been 2.6% over the last 5 years but was only -.4% this quarter. Earnings surprises were rewarded with a gain of 2.1% compared to the average of only 1%. Certainly the recovery from the December losses is a factor.

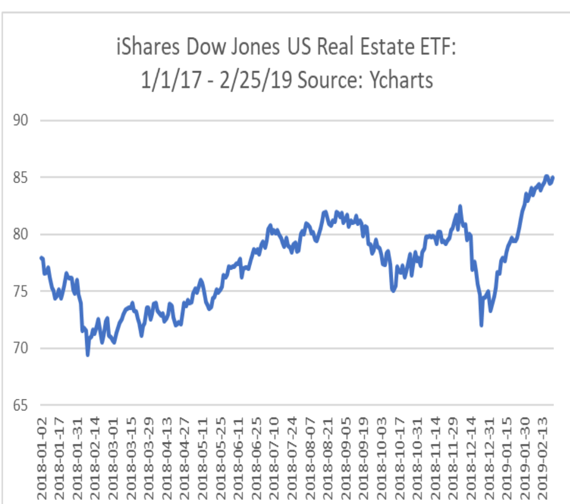
- Guidance is important and causing some analysts to raise a red flag as 68 companies issued forward guidance that was negative and only 25 companies posted positive guidance for 2019 (Factset).
- The robust earnings growth combined with the 13% stock market decline in Q4 dropped the forward P/E ratio to 16.2, below the 5-year average of 16.4 but below the 10-year average of 14.7 (Bloomberg).
- FactSet projects a year over year decline of 2.7% for earnings in Q1 even though they expect a 5.2% rise in revenues. The profit margin is expected to decline to 10.8%, the first decline since 2016.

The Powell Put

The "Powell Put", named after Fed Chairman Jerome Powell, refers to the point in market depreciation where the Fed would step in and provide stimulus or, at a minimum, curtail quantitative tightening. Quantitative tightening amounted to a commitment to both reduce the Fed's balance sheet and continue to raise interest rates. The Fed began reducing the balance sheet in October of 2017 by reducing the amount of Treasuries and mortgage-backed securities it is holding by approximately $405 billion (Federal Reserve). Minutes from the January Federal Reserve Meeting were published in late February. Powell used the word "patient" to describe the central bank's new stance on policy. The minutes also highlighted the objective to end the reduction of bonds on the central banks balance sheet by the end of 2019.

- The Federal Reserve holds $3.8 trillion in bonds on its balance sheet (CNBC).
- Recent Fed minutes identified risks and uncertainties in their economic outlook, concluding that a "patient" approach to monetary policy was prudent.
- The Federal Reserves target range for the fed funds rate continues to be between 2.25 and 2.5%.
- As of the market close on February 22, the S&P 500 ETF, SPY, had appreciated 11.71% (Bloomberg).
- Powell's comments appear to have slowed down pessimism towards the overall economy and market as consumer confidence in February rebounded from January.

REIT Rebound

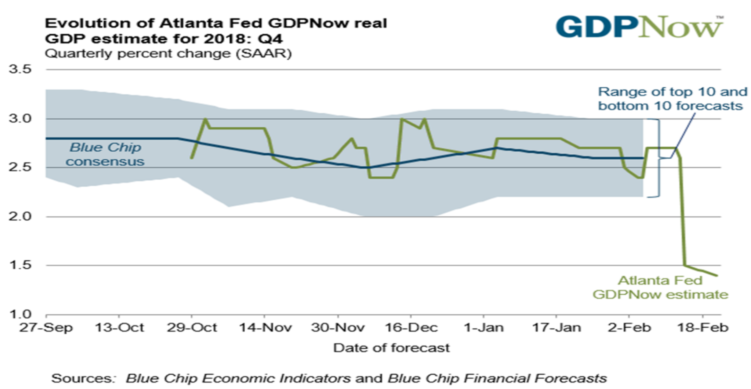


We've seen asset prices rise overall so far this year. One asset class in particular has done quite well by just about any measure. Real Estate Investment Trusts, or REITs, have recouped most of their losses from last year. Based on the Dow Jones U.S. Real Estate Index, which measures the performance of REITs and other companies that invest directly or indirectly in real estate through development, has surged roughly 14% so far this year, compared to a gain of roughly 12% for the broader S&P 500 Index. Last year, REITs had declined by as much as -13% in the fourth quarter of last year (YCharts).

- REIT returns have been under pressure in recent years. One possible reason for this is that investors in general may be leery over owning property and real estate in a rising rate environment. At some point, higher rates can impact affordability, which makes financing real estate deals more challenging.
- However, given the change in the Federal Reserve's interest rate outlook, investors have flocked to REITs. No longer is the Fed bent on raising rates. As a consequence, this more accommodative stance has helped boost net asset values and enhance liquidity. It's no surprise that REITs has done so well this year.

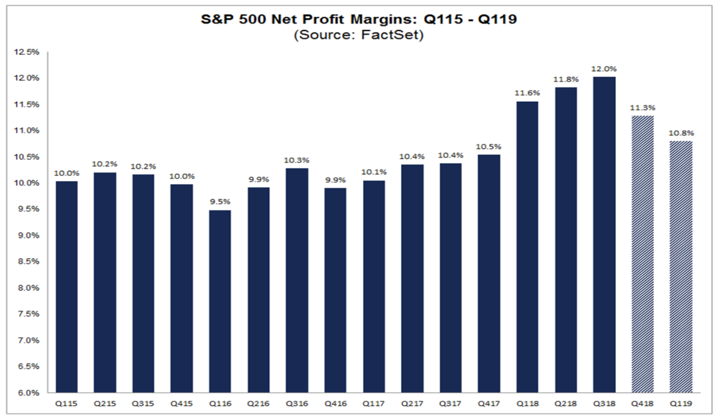
Macro View – GDP Estimates a Drop

There is substantial discussion as to when a recession will occur and what will trigger the recession. A meaningful drop in the Atlanta Fed's estimate reading of GDP caught the financial community's attention. The estimate for Q4 2018 GDP dropped from over 2.5 to just above 1.5. Much of the drop pointed toward weak industrial production, retail sales, and personal consumption data. Analysts are peeling back the layers to further identify potential causes of GDP turning lower. New orders on non-defense capital goods have declined in the last 4 out of 5 months. The yield curve continues to narrow, flatten, and, in some instances, invert. The Census Bureau released the durable good report in late February. Although the report was positive, up 1.2%, the ex-transportation reading only appreciated by .1% (Census Bureau). Lastly, the moving average of initial unemployment claims is in an upward trend.



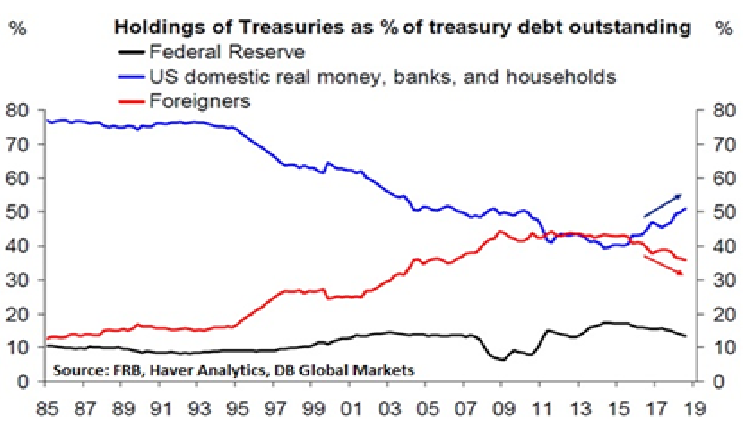
Taking Stock – Profits in Decline

According to Factset, the S&P 500 is projected to report the first year over year decline in net profit margin since Q4 2016. The chart below shows Q4 2018 net profit margin of 11.3% followed by an estimate for Q1 2019 dropping to 10.8%. While profit margins saw an estimated drop, year over year growth of revenues increased. According to Factset, despite the drop in profit margins, analysts are still expecting net profit margins for Q2-Q4 2019 to be higher than the estimate for Q1. Estimates for S&P 500 net profit margin Q2-Q4 2019 are 11.5%, 11.9%, and 11.7%, respectively. Net profit margin estimates by sector displayed Q1 estimates led by real estate estimated at 34.1%, information technology at 20.1% and financials at 17.4%. Consumer discretionary, consumer staples, and energy rounded out the sectors with the lowest estimated Q1 2019 net profit margins at 6.1%, 6.0%, and 5.5%, respectively (Factset).



Fixed Income - Sayonara

The latest data from the Federal Reserve Bank shows demand for U.S. Treasuries from foreigners continues to wane. After hitting a peak of 42% in 2016, the percentage of Treasuries held by non-U.S. investors declined to 36% and the trend is accelerating. In December alone, foreigners sold a record $91B in U.S. stocks and bonds, 85% of that total were government bonds. The lack of interest from foreigners to hold Treasuries has not negatively impacted the bond market, as there is a strong domestic bid from pension funds and banks for Treasuries. Interest rates fell from 3.20% in November to 2.60% in January as risk assets sold off and a flight to safety occurred. Issuance of Treasuries with deficits near record highs and the Fed reducing their holdings of government bonds is a concern for the future, particularly when the risk-on trade resumes.



Technical - Confidence Trending Lower

Correlations in charts are important to technical traders as it highlights points of divergence as well as inflection points. The latest data released from the Conference Board, NFIB and DB Global Research demonstrates how severe the fall in optimism was in December and January. Given that there is usually a 6-month lag between the peak in consumer confidence and a recession, concern over the 2nd half of 2019 is growing. Consumer spending represents nearly 70% of domestic GDP and is heavily influenced by the level of confidence. Expectations about the future economy have fallen to the lowest level in almost a decade. The decline in small business optimism suggests the labor market may have peaked as small businesses are the growth engine for jobs. If these two charts do not reverse in the near future the likelihood of a recession increases significantly.

Target Date Funds and Path Dependent Returns

Clint Pekrul, CFA

Many of our clients may have heard of target date funds (TDFs), which are quite popular in our industry. TDFs offer a simple asset allocation strategy over the course of someone's investment time horizon. In general, the asset allocation is a basic mix of stocks and bonds that changes as you approach the target date. For example, a TDF that matures in thirty years might have an allocation that is almost 100% in equities today. As time goes by and you approach the target date, the allocation might become almost 100% in bonds. At the target date, the TDF might be 100% invested in cash or short-term Treasuries.

The idea behind a TDF is that as you approach retirement (i.e. the target date), your risk tolerance declines. That is, you move from the accumulation phase of your investment horizon, where you can take more equity risk, to the income producing phase of your investment horizon, where you take less investment risk with high quality, short duration bonds. A TDF can provide a disciplined asset allocation strategy. For many investors, a TDF represents a simplistic, buy-and-hold fund that manages the asset allocation internally.

In investment parlance, a TDF represents a path-dependent strategy. That is, the asset allocation mix follows a path as you approach the target date. Some industry professionals refer to TDFs as a "glide-path" strategy. The mix of stocks and bonds is dependent on one primary factor – time. While some TDFs might employ active managers that seek to provide alpha, or returns in excess of the broader market, by and large, TDFs generally employ passive investment vehicles like index funds. Part of the appeal of TDFs are their cost structure, which can be relatively low.

In our view, TDFs have some potential issues that investors should consider. As a path dependent strategy, the asset allocation mix is set in advance. While that might be part of the appeal of TDFs, it is also one of the biggest risks. Imagine a scenario where the TDF's underlying assets are substantially invested in equities. Further assume that equites begin to falter, much like they did over the past few recessions of 2008 and 2000-2002. But because of the time factor embedded in TDFs, the asset mix begins to change to bonds (i.e. the underlying mix of assets changes because you are getting closer to the target date).

Under this scenario, you could be forced to sell equities are the worst possible time (e.g. at the depths of a recession). Now further assume that after a recession, interest rates begin to rise. In this example, you could be buying bonds in a rising rate environment, while the equities you were just forced to sell begin to recover. In a worst-case scenario, you realized losses not only on the equity side of the portfolio, but on the bond side of the portfolio as well.

Our point is that TDFs might be overly simplistic. Think of all the casual assumptions you are making about the performance of various asset classes over the course of the TDF. Markets don't necessarily behave the way we think they will, especially over the course of several decades. Being forced to shift your mix asset mix simply because time has passed might not be the best strategy.

We are not suggesting that you shouldn't address your asset allocation as you approach retirement. We're suggesting that there might be a better approach than the overly simplistic structure used by TDFs. Our approach to portfolio management at PCM is through the lens of risk management. Clients familiar with our Dynamic Risk Hedging (DRH) overlay understand that we make modifications to our portfolios based on changes in price volatility and return correlations. This helps us ensure that our portfolios remain diversified and adhere to certain risk tolerances.

The advantage of DRH over TDFs, in our view, is that we are not forced to change our allocation mix simply because time has passed. While we might reduce our exposure to riskier assets at times, we have a methodology to help reposition your portfolio back into risker assets if the volatility is favorable. Potentially, our portfolios can help keep you invested in riskier assets for longer, which means a longer accumulation phase. With guardrails in place, DRH can help you avoid falling into a deep hole (e.g. declines of 40% or more) from which you can not recover. This means not following a casual "glide path".

Q: What is the potential economic impact of the State of Emergency declaration?

Much is made about the declaration because both sides are trying to score political points, particularly with their base where most of the fundraising occurs. Declarations of emergency are far more common than a casual observer of news would be led to believe. President Obama declared a national emergency regarding Venezuela in 2015. When questioned whether Venezuela posed a national security threat to the U.S. he quickly downplayed any threat and stated that was what he had to say under the law in order to trigger the emergency powers; an honest admission that these powers are used to accomplish policy goals. The money that the President wants and that Congress has refused to approve for a barrier on part of the southern border is actually a rounding error of the amount spent each year (less than .5%).

The right-leaning Cato Institute has estimated that illegal immigration costs $113B per year while the left-leaning Center for Immigration Studies suggest a lifetime cost to taxpayers around $65,000 per illegal immigrant. Regardless of the actual cost, this debate is political and not economic. If anyone seriously disagrees on that point, simply look at past statements that politicians on both sides of the aisle have made about illegal immigration. They have either become far more enlightened in their thinking or are just being politicians.

Interestingly, I came across an article recently in the Washington Post (which, by the way, is owned by Jeff Bezos). The article referenced how Trump's emergency declaration over the border wall could bypass the competitive construction bid process. Now, the Post and President Trump might not see eye-to-eye on most issues, so there might be some bias in the article. But given Trump's background in construction, I can't help but wonder if there's more to this state of emergency than meets the eye. As always, a good way to understand what's truly going on in Washington is to follow the money. Sorry if I come across as jaded, but money talks in politics. It will be interesting to follow the progress on the wall construction, and in particular who ultimately lands the construction bids. The only other real impact of the state of emergency is how it will likely clog the courts. I believe there are already 16 states that are suing to prevent the declaration of emergency. But overall, I don't think there will be any real economic impact from the state of emergency at the macro level. At the end of the day, I think it is just political posturing.

Q: Is there anything new about the New Green Deal?

There is actually a lot new in the NGD and I think it probably has many who align on the political left of center very nervous. While I may be giving Ms. Ocasio-Cortez more credit than is deserved, her strategy may prove to be an effective way to not only bring climate change into mainstream conversation but also result in actual changes in carbon emissions. The GND moved the needle so far by suggesting the seemingly absurd like renovating every building in America, eliminating every combustible-engine vehicle, or removing farting cows over the next 10 years. Clearly nothing like this is going to be done and Trump and millions of others will still be able to eat a Big Mac whenever they want. By starting at such an extreme point, a compromise might ultimately be far more climate friendly.

There will be many more opponents than supporters when you get outside the walls of Congress. Terry O'Sullivan, the President of the Laborer's International Union of North America, called the GND a fairy tale. The AFL-CIO leader, Richard Trumka, had scathing comments about the GND and the impact it would have coal miners and power plant workers. The absurdity of many of the proposals included in the GND and the infamous talking points that were released did not stop most Democratic politicians considering running for President in 2020 from supporting it. Maybe that is the biggest surprise.

Ever hear of Energiewende? It's German for energy transition and describes the country's efforts to transition to low carbon, renewable energy sources. It was passed by the German legislature in 2010 as an attempt to cut carbon emissions by 80% to 90%, and wane the country off the use of coal and nuclear energy. Sound familiar? So, to me, there's really nothing new, or original, about the New Green Deal. All we have to do is look at Germany and see a very similar plan. The idea of cutting carbon emissions and increasing the use of renewable energy has been around for a long time. The most liberal part of the Democratic party has resurrected the New Deal framework of the 1930s to fundamentally change the economic landscape in the U.S. I guess you could say that the scope of the New Green Deal is unprecedented in this country. Some Democrats, if given the power in Congress, could be fairly aggressive in pursuing their green agenda. What would be surprising is if the New Green Deal receives some support from the GOP, who have largely dismissed climate change legislation.

All weights as of March 1, 2019

Income

Mortgage Backed Bond	39.00%
Investment Grade Credit	17.00%
High Yield Bonds	14.00%
Preferred Stock	12.00%
US Dividend	5.00%
US REITs	6.00%
Short (Inverse) Treasury Bond	5.00%

Balanced Income

US Dividend Equities	12.00%
International Dividend Equities	11.00%
US REITs	12.00%
High Yield Bonds	30.00%
Long Term Treasuries	28.00%
Short (Inverse) US Equity	5.00%

US Growth

Low Volatility Factor	20.00%
High Quality Factor	10.06%
Small Cap Factor	9.85%
Value Factor	21.00%
Momentum Factor	8.44%
Long Term Treasuries	23.00%
Short (Inverse) U.S. Equity	8.00%

Global Growth

Low Volatility Factor	13.00%
High Quality Factor	8.00%
Small Cap Factor	6.00%
Value Factor	11.00%
Momentum Factor	5.00%
Developed Market Equity	17.00%
Emerging Market Equity	10.00%
Long Term Treasuries	25.00%
Short (Inverse) U.S. Equity	5.00%

Weights are approximations only and subject to change.

Fundamental Technical Discipline

15455 Gleneagle Dr., Suite 100
Colorado Springs, CO 80921

Phone: 719.203.6926
Fax: 719.465.1386

Email: info@pcmstrategies.com
Website: www.pcmstrategies.com